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No. 93-567

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

CONTINENTAL ILLINOIS CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the court of appeals incorrectly held, contrary to this Court's decision in *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), that a taxpayer must report funds as income upon receipt even though the taxpayer is contractually obligated to repay those funds unless contingencies occur that are outside of the taxpayer's control.

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The American Bankers Association hereby respectfully submits this brief as amicus curiae in support of the Petitioner in accordance with the provisions of Rule 37.2 of the Supreme Court Rules. Both parties have consented to this filing, and their written consents are filed with this brief.

INTEREST OF AMICUS CURIAE

The American Bankers Association ("ABA") is the principal national trade association of the commercial banking industry in the United States. ABA members are located in each of the fifty states and the District of Columbia and represent banks of all types and sizes—money center, regional and community banks. ABA members hold approximately ninety percent of the domestic assets of United States banks.

The decision of the Seventh Circuit Court of Appeals in this case[1] raises a tax issue of substantial importance to commercial banks across the nation. The tax treatment of the CAP loan product offered by Continental Bank for the years under audit would be significant both to the tax treatment of that product offered by other banks and to the treatment of similar bank-customer financial transactions which involve receipt of funds by the lender which are subject to repayment to the borrower based on future conditions. Since the CAP loan product was widely offered by commercial banks, the decision in this case will impact bank cases where the issue was raised on audit. In addition, the Seventh Circuit's application of the principles in the *Indianapolis Power and Light*[2] case raises serious questions about the scope of the this Court's ruling in that case. Banks which are attempting to develop innovative financial products for their customers should not be left in a state of uncertainty with respect to the fundamental tax law criteria for determining how a taxpayer should treat the receipt of funds subject to repayment.

The American Bankers Association is in a unique position to express the views of the financial institutions across the country regarding the issues raised in this case. The ABA has a broad base of membership including banks of all sizes and types. More specifically, the ABA serves as a clearing house of information for its member banks by working with committees of bankers who are experts on a wide variety of commercial banking practices of all types,

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[1] 998 F 2d. 513 (1993).

[2] 493 U.S. 203 (1990).

including lending innovations. Moreover, the ABA has developed and maintained for 25 years a very active role in the public debate over the tax treatment of financial institutions and their products. The ABA maintains regular liaison with the Congressional tax-writing committees, the IRS Assistant Chief Counsel (Financial Institutions and Products) and the IRS Industry Specialist—Commercial Banks. The ABA has also filed *amicus curiae* briefs in two recent U.S. Supreme Court cases which affected the taxation of commercial banks—*Newark Morning Ledger Co. v. U.S.*[3] and *Quill Corp. v State of North Dakota*[4]. In light of ABA's clearing house function for banking practices and active participation in the issues surrounding taxation of banks and their products, the ABA has the experience and knowledge base from which to comment about the significance of this case to the commercial banking industry. Therefore, the ABA believes that its views would be of assistance to the Court in determining whether this matter merits further review.

REASONS FOR GRANTING WRIT

I. The Seventh Circuit ruling on the tax treatment of CAP loans will create adverse consequences throughout the banking industry.

The CAP loan product offered by Continental Bank during the tax years in issue constituted a significant financial innovation for commercial loan customers. In an environment of uncertain interest rates lenders might be disadvantaged by a traditional fixed rate

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[3] 113 S. Ct. 1670 (1993).

[4] 112 S. Ct. 1904 (1992).

loan and borrowers might be disadvantaged by a traditional floating rate loan. In contrast, the CAP loan product afforded both parties to the transaction an opportunity to accommodate the changing interest rate environment by adjusting the interest rate at the end of the transaction, within parameters set by the original contract. The CAP loan product, including variations, has been widely offered throughout the commercial banking industry.

The Internal Revenue Service effectively confirmed the significance of the CAP loan product by making that issue one of only five "coordinated issues" for the commercial banking industry. The coordinated examination program was developed in 1966 as a way to enhance examinations of large corporate taxpayers.[5] While the coordinated issues for the commercial banking industry have changed somewhat since the 1960's, since 1986 there have been five coordinated issues for the commercial banking industry, without change.[6]

The effect of designation of a coordinated issue by the IRS is to require all IRS agents to challenge on audit the tax treatment of CAP loan products and require the taxpayer to recognize the entire amount of funds received as taxable income when received,

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[5] As background on the IRS coordinated examination program, see statement of Fred T. Goldberg, Jr. Commissioner of Internal Revenue before the Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs, April 17, 1991.

[6] Five issues for commercial banks are: (1) accrual of interest on non-performing loans (2) recognition of interest on CAP loans (3) amortization of the purchase price paid for core deposits (4) the character of gain or loss from the sale of foreclosed property, and (5) the creditability of certain foreign withholding taxes.

just as it did in Continental's case. The identification of CAP loans as a coordinated issue caused many bank taxpayers to have this issue raised on audit and it is not uncommon for large commercial banks to have audits open for 10 years or more because of the complexity of the issues involved. As a result, the absence of Supreme Court review of this case will mean that many banks outside the Seventh Circuit will be left with uncertainty about the tax treatment of CAP loans.

One of the principal benefits of CAP loans is to permit lenders and borrowers to strike a mutually acceptable agreement on a loan transaction even in the face of a changing interest rate environment. Bank lenders expect to continue to need CAP loans or alternative financial products as a way to facilitate the pricing of loans. CAP loans are a particularly attractive product for smaller commercial banks with assets of less than $1 billion, because these banks are reluctant to offer more expensive and sophisticated financial products such as derivatives. The ABA thus believes that CAP loans will continue to be a very attractive financial product both for small bank lenders and for middle market and small commercial borrowers.

II. The Seventh Circuit decision on CAP loans has created uncertainty about the tax treatment of financial products which could stifle future financial innovation.

The Court should accept the *Continental* case for review in order to clear the air on the treatment of rebated funds, lest the current uncertainty impair the future consideration of innovative financial products which involve the same tax issue. The prospects for

financial innovations that involve the same tax issue as the *Continental* case seem almost limitless. One recent example illustrates the chilling impact of the uncertain state of the law on product development.

A product under consideration by a large regional bank in the upper midwest involves construction lending during a period when the building was being built up, to be replaced by permanent financing once the project is completed. Traditionally, construction lending is at a rate higher than the permanent financing, thereby creating a financial incentive for the builder to complete the project as quickly as possible. In a rising interest rate environment, however, the traditional gap between construction financing and permanent financing may not be sufficient incentive. Therefore, this large regional bank is considering incorporating into its construction lending contracts a provision for rebate of a portion of interest to the borrower, if a permanent lender is found within a specified period.

This construction lending rebate is very similar to the CAP loan product offered by Continental Bank. In both cases there would be an agreement at the outset that the borrower would pay the lender a stated rate but at some period in the future the borrower may receive an interest rebate based upon events beyond the lender's control. Thus, both cases involve the question of whether the receipt of funds which might be rebated under the agreement have to be recognized as income at the time of receipt. The bank which is considering the construction loan product and other banks that may offer the same product or variations or innovative applications of interest rebate loans should be entitled to know whether or not the

Supreme Court ruling in the *Indianapolis Power and Light* would apply to their situation. We believe that there are many other financial innovations which involve the tax principles of the *Continental* case.

This Court's decision in *Indianapolis Power and Light* established clear expectations about the tax treatment of financial institution products that involved a rebate of interest to the borrower. Now that the Seventh Circuit opinion in the *Continental* case has confused those expectations, it is incumbent on this Court to resolve the conflict. This issue is a matter of broad importance to the industry and we urge the Court to address it now.

III. The Seventh Circuit misconstrued the principles of *Indianapolis Power and Light* and failed to apply them to the CAP loans offered by Continental Bank.

This Court's decision in the *Indianapolis Power & Light* case set clear rules for determining when the receipt of funds would not constitute income under Section 61(a) of the Internal Revenue Code. The Court directed that a determination be made based on the rights and obligations of the party at the time the money was paid and said "the key is whether the taxpayer has some guarantee that he will be allowed to keep the money."[7]

Like the taxpayer in that case, Continental Bank had an "express obligation to repay" the interest received over the CAP loan rate, based on factors outside its own control. The bank did not have complete dominion over the "excess interest" and the bank's experience was that there was a high probability that

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[7] *Commissioner v. Indianapolis Power and Light*, 493 U.S. at 210.

the funds would have to be repaid to the borrower. Therefore, the bank should not have to recognize as income the "excess interest" at the time the money is paid.

The American Bankers Association believes that the Seventh Circuit incorrectly interpreted the rule in the *Indianapolis Power & Light* case and failed to apply it in the case of the CAP loan product. Moreover, the Seventh Circuit's decision substantially confuses the recognition of income rules for financial transactions like CAP loans. It simply declares that CAP loans are a gray area between deposits (no recognition of income) and warranties for defective goods (which reduce the certainty of a seller's stream of income) and concludes the Commissioner did not abuse his discretion by requiring recognition of income. The "gray area" approach is inadequate as a guide for financial institutions attempting to devise products for customers so that both parties will know at the outset the tax consequences of the transaction. A bank would not be able to determine whether a new product such as the construction loan rebate described earlier would be in the "gray area" and if so, whether the Commissioner might exercise his discretion one way or another.

CONCLUSION

The commercial banking industry and other similarly situated taxpayers are understandably confused about the recognition of income in the case of financial products such as CAP loans as a direct result of the conflict between the Supreme Court's ruling in *Commissioner v. Indianapolis Power & Light*, and the Seventh Circuit's decision in *Continental Illinois Cor-*

poration v. Commissioner. The only remedy for this conflict is for this Court to grant the petition for a writ of certiorari in this case.

Respectfully submitted,

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